United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

75-6131 B

United States Court of Appeals

FOR THE SECOND CIRCUIT

NO. 75-6131

THE AETNA CASUALTY AND SURETY COMPANY,
Plaintiff-Appellant

vs.

UNITED STATES OF AMERICA,
Defendant-Appellee

ON APPEAL FROM the UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF CONNECTICUT

BRIEF OF THE PLAINTIFF-APPELLANT

To be argued by:
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PRELIMINARY STATEMENT

Pursuant to Section 28,
Rules of the Court of Appeals
for the Second Circuit

The decision appealed from was rendered by the Honorable M. Joseph Blumenfeld. The citation is *The Aetna Casualty and Surety Company v. United States of America*, 403 F. Supp. 498 (D. Conn. 1975).

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STATEMENT OF THE ISSUES

(1) Did the District Court err in deciding that the plaintiff is barred by Section 381(b)(3) of the Internal Revenue Code of 1954, as amended, from carrying back net operating losses it incurred in taxable periods subsequent to the merger of Old Aetna with New Aetna to taxable periods prior to such reorganization?

(2) Did the District Court err in deciding that the merger of Old Aetna with New Aetna qualified exclusively as a reorganization described in Section 368(a)(1)(C) of the Internal Revenue Code of 1954, as amended, and not as one described in Section 368(a)(1)(B) as well, thereby barring the carryback of the net operating losses incurred by the plaintiff subsequent to the merger of Old Aetna to taxable periods prior to such reorganization?

STATEMENT OF THE CASE

The plaintiff, The Aetna Casualty and Surety Company, brought this action against the defendant, United States of America, by filing a Complaint in the Federal District Court, District of Connecticut, on August 14, 1973. In its Complaint, the plaintiff sought recovery of $4,071,655.21 in Federal income taxes paid to the defendant in respect of the calendar year 1963, plus deficiency interest paid thereon of $395,975.38, with interest on such amounts as provided by law.

In its Complaint the plaintiff asserted that it was entitled as the successor by statutory merger effected December 29, 1964, to The Aetna Casualty and Surety Company ("Old Aetna"), to a carryback of its net operating losses for the taxable period December 30, 1964 through December 31, 1964 and the calendar year 1965 in the amounts of $39,597.00 and $11,554,725.00, respectively, to the calendar year 1963 of Old Aetna. The plaintiff based its claim on two alternative grounds:

> The merger of Old Aetna into the plaintiff constituted a mere change in identity, form, or place of organization within the meaning of Section 368(a)(1)(F) of the Internal Revenue Code. Complaint, ¶ 5 (A7).
>
> Alternatively, Old Aetna and the plaintiff were one and the same corporation and the reorganization constituted nothing more than an acquisition by Aetna Life of the Old Aetna stock held by its minority stockholders. Complaint, ¶ 6 (A8).

Exhibit A to the Complaint is a copy of the December 27, 1967 claim for refund of $2,886,942.44 with respect to the Federal income tax of Old Aetna for the taxable year 1963. Exhibit B to the Complaint is a copy of the September 26, 1972 claim for refund of $4,071,655.21 with respect to the Federal income tax of Old Aetna for the taxable year 1963, plus deficiency interest paid of $395,975.38.

Jurisdiction is founded upon 28 U.S.C. Section 1346(a). This action is a civil claim against the United States of America for the recovery of Federal income tax paid and interest thereon, alleged to have been erroneously and illegally assessed and collected or otherwise described within Section 1346(a).

The defendant filed an Answer dated October 12, 1973, a Pretrial Memorandum dated November 27, 1973, and an Amended Answer dated January 29, 1975.

On October 15, 1974 the parties filed a joint Stipulation of Facts. The parties disagreed as to none of the material facts. Paragraph 4 of the Stipulation of Facts stated that:

> The controversy in this case relates to a corporate reorganization of Old Aetna that occurred on December 29, 1964, the characterization of which will control the Federal income tax treatment of a subsequent net operating loss, all as more particularly set forth herein.

The Stipulation of Facts includes 10 Exhibits, generally relating to the approval of the December 29, 1964 reorganization by the directors and shareholders of Old Aetna, New Aetna, Aetna Life Insurance Company and the Insurance Commissioner of the State of Connecticut, and copies of the legal documents involved. Exhibit C to the Stipulation of Facts is a copy of the ruling request filed with the Internal Revenue Service relating to the Federal income tax treatment of the proposed reorganization. Exhibit E is a copy of the October 23, 1964 ruling letter of the Internal Revenue Service holding that the reorganization would constitute a reorganization described in Section 368(a)(1)(C) of the Internal Revenue Code of 1954, as amended. Exhibit J to the Stipulation of Facts is a copy of the August 28, 1968 memorandum of technical advice to the District Director of Internal Revenue from the National Office of the Internal Revenue Service with respect to the issue in this case.

On October 8, 1974, the defendant filed a Notice of Deposition of Steven B. Middlebrook, requesting that the deponent

bring with him all documents "relevant to the business purpose for undertaking the reorganization in issue in the action entitled above." Mr. Middlebrook's deposition was taken on October 11, 1974.

On February 20, 1975, the defendant filed its Motion for Summary Judgment and a brief in support thereof. On February 21, 1975, the plaintiff filed its Motion for Summary Judgment and a brief in support thereof. Reply briefs were filed on March 24, 1975 and on April 23, 1975 by the plaintiff, and on March 24, 1975 by the defendant.

The motions of the parties for Summary Judgment were heard on oral argument on April 28, 1975 before the Honorable M. Joseph Blumenfeld. In a Memorandum of Decision dated October 15, 1975, Judge Blumenfeld denied the plaintiff's motion and granted the defendant's motion for Summary Judgment. Pursuant to that Memorandum of Decision, judgment for the defendant was entered on December 10, 1975.

On December 12, 1975, the plaintiff filed with this Court a Notice of Appeal, which was amended on January 29, 1976.

STATEMENT OF THE FACTS

This is a Federal income tax refund suit seeking a carryback of post-reorganization net operating losses to pre-reorganization taxable periods. If the carryback is permitted, the plaintiff will be entitled to recover $4,071,655.21 in Federal income taxes paid to the defendant for the calendar year 1963, plus deficiency interest paid thereon of $395,975.38, with interest on such amounts as provided by law. Stipulation of Facts, ¶ 40 (A22).

The plaintiff, The Aetna Casualty and Surety Company ("New Aetna"), is a Connecticut corporation which writes and sells liability, fire, theft, property damage and surety insurance. The plaintiff is the successor by statutory merger, effected December 29, 1964, to The Aetna Casualty and Surety Company ("Old Aetna"). Old Aetna was a Connecticut corporation writing and selling liability, fire, theft, property damage and surety insurance.

Aetna Life Insurance Company ("Aetna Life") is a Connecticut corporation which writes and sells life, accident, and health insurance throughout this country and Canada. Prior to December 29, 1964 and continuously since 1957, Aetna Life had owned 4,312,535, or 61.61 percent, of Old Aetna's 7,000,000 issued and outstanding shares of common stock. Stipulation of Facts, ¶ 6 (A14-A15).

In order to eliminate the publicly held 38.39% minority interest in Old Aetna, Aetna Life organized a wholly owned shell corporation, New Aetna, which merged with Old Aetna, following which Aetna Life owned 100% of its fire and casualty subsidiary and the former shareholders thereof owned stock of Aetna Life. Stipulation of Facts, ¶¶ 8, 16-18 (A15-A18).

To effectuate this plan, Aetna Life transferred 13,300,000 shares of its voting common stock to New Aetna in exchange for the 1,000 shares of New Aetna's common stock. New Aetna then merged with Old Aetna, the Old Aetna shareholders re-

ceiving Aetna Life shares in the ratio of 1.9 shares of the common stock of Aetna Life stock for each share of Old Aetna stock. All Old Aetna stock was either retired or cancelled. Stipulation of Facts, ¶ 8 (A15); Memorandum of Decision 4-5 (A111-A112).

On October 21, 1964, the Insurance Commissioner of the State of Connecticut issued a Finding and Final Order approving the proposed plan. Stipulation of Facts, ¶ 12 (A16). On October 22, 1964, the Commissioner of Internal Revenue issued a ruling characterizing the merger as a reorganization described in Section 368(a)(1)(C) of the Code. Stipulation of Facts, ¶ 13 (A16-A17).

On December 29, 1964, the plan of reorganization was carried out as described above. Stipulation of Facts, ¶13 (A16-A17). As a result of the reorganization, Aetna Life exchanged its common stock for the publicly held common stock of Old Aetna. No shareholder of Old Aetna exercised the statutory right of appraisal accorded dissenting shareholders under Connecticut law. Stipulation of Facts, ¶ 20 (A18). The common stock of Old Aetna was immediately cancelled. The Aetna Life common stock received by Aetna Life was immediately retired. Stipulation of Facts, ¶ 18 (A17-A18). Upon the effectiveness of the reorganization, New Aetna, which previously conducted no business, succeeded to all of the business of Old Aetna. The plaintiff continued that business without change. Stipulation of Facts, ¶¶ 22-32 (A18-A20).

During the calendar year 1964, the plaintiff incurred net operating losses of $7,253,144. Stipulation of Facts, ¶ 33 (A20). Upon auditing this period, the Internal Revenue Service allocated, on a pro rata basis, $7,213,547 of the net operating loss for the calendar year 1964 to the period preceding December 29, 1964, and $39,597 to the period thereafter. Stipulation of Facts, ¶ 33 (A20). During 1965 the plaintiff incurred net operating losses of $11,554,725. Stipulation of Facts, ¶ 34 (A20).

The Internal Revenue Service permitted the plaintiff to carry back the $7,213,547 net operating loss allocated to the period prior to the December 29, 1964 reorganization, to offset a part of Old Aetna's 1963 taxable income. No portion of the plaintiff's net operating losses for the periods subsequent to December 29, 1964 was allowed by the Internal Revenue Service as a carryback to offset the remaining $8,525,816.75 of Old Aetna's 1963 taxable income, even though these losses were in connection with the business activity which had formerly been carried on prior to December 29, 1964, and which the plaintiff continued to carry on thereafter. Stipulation of Facts, ¶¶ 34, 35, 38 (A20-A21). The plaintiff would have been entitled to the carryback sought herein if the December 29, 1964 reorganization had not occurred and it had continued to carry on its business. Stipulation of Facts, ¶ 38 (A21).

As a result of the disallowance for the calendar year 1963 of the carryback of net operating losses incurred in periods subsequent to the merger of Old Aetna with New Aetna, the plaintiff paid to the defendant $4,071,655.21 in Federal income taxes and $395,975.38 in deficiency interest. These amounts have not been returned or in any way refunded or credited. Stipulation of Facts, ¶¶ 36, 38, 39 (A21).

If the $11,594,322 net operating loss carryback is allowed, the plaintiff is entitled to a refund of $4,071,655.21 of Federal income taxes paid for the calendar year 1963, plus $395,975.38 deficiency interest paid thereon, with interest on such amounts as provided by law. Stipulation of Facts, ¶ 40 (A22).

ARGUMENT

I

INTRODUCTION

The District Court held that Section 381(b)(3) of the Internal Revenue Code of 1954, as amended ("Code") prohibited the carryback of the plaintiff's ("New Aetna") net operating losses incurred in 1964 and 1965 against the income of its predecessor ("Old Aetna") for 1963. The Court found that the reorganization of Old Aetna and New Aetna was a reorganization described exclusively by Section 368(a)(1)(C) and concluded on that basis that the restriction on loss carrybacks which appears in Section 381(b)(3) was fully applicable.

The opinion of the District Court includes two major, and distinct, legal conclusions. It is respectfully submitted that each of those conclusions was in error and that either error requires reversal of the decision of the District Court.

First, the District Court wholly misconceived the purpose and intent of Section 381(b)(3). The Court assumed that Congress' aim was to prevent the "assignment" of loss carrybacks from one corporate entity to another. Memorandum of Decision 17 (A124). In fact, the legislative purpose was simply to avoid the practical and technical difficulties of divisional accounting, difficulties which arise only when two *existing* operating companies are amalgamated. Where an operating company merges into a shell corporation, as in this case, Section 381(b)(3) has no sensible application.

Second, the District Court erred in holding that the reorganization was one that is described *exclusively* by Section 368(a)(1)(C). Memorandum of Decision 20 (A127). Having conceded "that a transaction may be described by two (or more) overlapping subsections of Section 368(a)(1)," Memorandum of Decision 14, n. 16 (A121), the Court should have found that the reorganization qualified as well under Section 368(a)(1)(B), in which event it should have further

found that the restrictions on carrybacks in Section 381(b)(3) do not apply. The Court's error was based, in part, on a misreading of the manner in which the reorganization occurred and on a refusal to apply the rationale of the Tax Court's decision in *Casco Products Corp.*, 49 T.C. 32 (1967), *appeal dismissed* (2nd Cir. 1968), a case which is identical to the present case in all important respects.

The Court's mistake about the status of the reorganization under Section 368(a)(1)(B) also led it to assume that the ruling which was received from the Internal Revenue Service in October, 1964 was inconsistent with the plaintiff's present claim for a deduction of loss carrybacks. While the Court did not assert that the alleged inconsistency was determinative, it seems plain that the consideration was a prominent motivating factor in the Court's decision. Memorandum of Decision 13 (A120). In fact there is no such inconsistency: the Court was wrong in concluding that the ruling depended upon a finding that the reorganization was exclusively a C reorganization.

These errors are explained in Parts II and III, and furnish independent grounds for reversal of the Court's decision. The plaintiff's arguments are offered in the alternative —moving, in a sense, from a broader view of the critical issue of statutory interpretation to a narrower one. Each is directed at the same proposition, however: namely, that the reorganization is not affected by the restrictive rules of Section 381(b)(3) and that the plaintiff's loss carryback should have been allowed.

II

THE PURPOSE OF SECTION 381(b)(3) MAKES IT CLEAR THAT CONGRESS DID NOT INTEND TO RESTRICT THE AVAILABILITY OF LOSS CARRYBACKS IN SINGLE-COMPANY REORGANIZATIONS. CONSISTENT WITH LEGISLATIVE INTENT, CORPORATE COMBINATIONS WHICH INVOLVE THE ACQUISITION OF AN OPERATING BUSINESS BY A SHELL CORPORATION NEWLY CREATED FOR THE PURPOSE SHOULD NOT BE TREATED AS WITHIN THE SCOPE OF SECTION 381(b)(3), EVEN IF TECHNICALLY WITHIN THE DEFINITION OF AN A, C OR D REORGANIZATION.

Where a business loss is incurred, it is available as a deduction against the business income of other years under the net operating loss provisions of Section 172[1] of the Code. Section 172 requires that the loss be carried back to the earliest of the three taxable years preceding the loss year, and then forward to the succeeding five years, until exhausted. Provision for loss carryovers has appeared in the tax law since 1918 when Congress first recognized that the annual accounting system might otherwise lead to "grave injustice." S. Rep. No. 617, 65th Cong., 3d Sess. 7 (1918). Taxpayers with fluctuating profits and losses would pay more taxes than competitors whose income was relatively constant from year to year. Equitable treatment thus required a smoothing device by which a taxpayer may "set off its lean years against its lush years, and . . . strike something like an average taxable income over a period longer than one year." *Libson Shops v. Koehler*, 353 U.S. 382, 386 (1957).

Much less clear, historically, has been the question whether an acquiring corporation in a tax-free reorganization may utilize for its own benefit the losses incurred by the transferor

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1 The deductions generally available to taxpayers under Section 172 are specifically allowable as deductions to casualty insurance companies, including the plaintiff, under Section 832(c)(10) of the Code.

corporation in years preceding the acquisition. Reacting to the uncertainty and excessive formalism of the prior law, Congress in 1954 adopted new and detailed statutory provisions whose aim was to promote clarity in this field and to emphasize "economic reality" instead of legal artifice. S. Rep. No. 1622, 83d Cong., 2d Sess. 52 (1954). Section 381 of the present Internal Revenue Code thus provides expressly for the carryover of a long list of attributes from transferor to acquiring corporation in tax-free asset acquisitions and related transactions. The transactions affected under Section 381 are those enumerated in Section 381(a), to wit, so-called A, C, D and F reorganizations, and certain liquidations of controlled subsidiaries.

Although net operating loss carryovers (i.e., carryforwards) are included among the tax attributes to which an acquiring corporation will now succeed, Section 381(b)(3) expressly restricts the availability of loss carrybacks in the case of certain of the transactions listed in Section 381(a). Where applicable, Section 381(b)(3) prohibits the carryback of an acquiring company's post-reorganization losses as an offset against the pre-reorganization income of the transferor company. The prohibition affects only those reorganizations described by Sections 368(a)(1)(A), (C) and (D) – roughly, reorganizations involving the acquisition by one corporation of the operating assets of another. It does not apply to reorganizations defined in Section 368(a)(1)(F) – mere change in name, identity or place of incorporation. Moreover, since Section 381(a) does not refer to the reorganizations defined in Section 368(a)(1)(B) (acquisitions of stock rather than assets) or Section 368(a)(1)(E) (recapitalizations of a single corporation) the carryback restrictions of Section 381(b)(3) do not apply to B and E reorganizations.

It is the plaintiff's contention that the District Court was in error in holding that Section 381(b)(3) extends to the reorganization of Old Aetna and New Aetna, and hence that the Court erred in denying the plaintiff's right to offset the very large operating losses which it incurred in 1964 and 1965

against the taxable income of Old Aetna for 1963. The central fact in the present case is that the plaintiff is a continuation of Old Aetna and that the scope and character of the enterprise was entirely unaltered by the substitution of a new formal entity for the old one. Old Aetna transferred all of its property and personnel to New Aetna. No additional income-producing assets were added thereby, and none was withdrawn. Only one set of operating assets was involved in the reorganization and only one "tax history" was present. Stipulation of Facts, ¶¶ 22-32 (A18-A20). Those assets and that history belonged to The Aetna Casualty and Surety Company, a taxpayer whose income had gone from positive to sharply negative within precisely the span of years covered by the relief provisions of Section 172.

If Section 381(b)(3) is applicable in these circumstances, as the District Court held, the effect, quite simply, is to cut three years from the life of the net operating loss deduction and to limit the plaintiff to a shorter period of averaging relief than is generally provided for in the statute. The plaintiff contends that the legislative object of Section 381(b)(3) was by no means so extreme and, indeed, that the subsection was aimed at quite a different goal. The objective of the provision was solely and simply to avoid the problem of inter-company apportionment of income and loss in those cases where a transferor and an acquiring corporation are *both* potential users of the carryback. In the present case, where there is only one potential user and hence no intercorporate conflict to resolve, the restrictions imposed by Section 381(b)(3) have no sensible application. Taking the purpose of Section 381(b)(3) fully into account, this Court can and should reverse the decision below by finding either (a) that Section 381(b)(3) does not apply to single-company reorganizations in which a new, shell corporation merely succeeds another with no alteration of the operating business, or (b) that except in consolidations involving two (or more) operating companies, the reference to an acquiring "corporation" in Section 381(b)(3) means an

entity with at least one prior period of status as a taxpayer or with operating assets of its own.

The District Court reached a decision adverse to the plaintiff by assuming that Congress' aim in Section 381(b)(3) was to limit the use of loss carrybacks to the same formal "entity" which incurred the loss. Memorandum of Decision 17 (A124). Since New Aetna was a different "entity" from Old Aetna, it followed, in the Court's view, that Congress must have intended to preclude the carryback privilege even though the same operating business continued throughout. In fact, however, as has long been understood, Congress' motive in adopting Section 381(b)(3) had little, if anything, to do with "entity" as such and much more to do with the practical and procedural difficulties of sharing, or apportioning, post-merger operating losses between constituent businesses. Simply put, the goal of Section 381(b)(3) is to obviate the need for divisional accounting where two or more pre-existing corporations are combined. The need would arise (as government counsel recently pointed out in the *Movielab* case) "if the corporations involved have different taxable years or if many predecessor corporations are involved and an apportionment of the NOL [net operating loss] must be made." *Movielab, Inc. v. United States*, 494 F.2d 693, 696 (Ct. Cl. 1974), *acquiesced in*, 1975 Int. Rev. Bull. No. 52, at 20. The alternative – allowing losses to be carried back against the prior income of *both* the transferor and the acquiring corporation – was thought to necessitate a degree of statutory elaboration which was not warranted in view of the relatively brief span of the carryback provision (one year prior to 1954) and the limited relief afforded. See Cohen, Phillips, Surrey, Tarleau, and Warren, *The Internal Revenue Code of 1954: Carry-overs and the Accumulated Earnings Tax*, 10 Tax L. Rev. 277, 280-81 (1955).[1]

[1] The same point was stressed by the Internal Revenue Service in its brief to the Tax Court in *Estate of Stauffer v. Commissioner*, 403 F.2d 611 (9th Cir. 1968), *acquiesced in*, 1975 Int. Rev. Bull. No. 52, at 20. Arguing that Section 381(b)(3) must apply whenever two pre-existing companies are combined, the government asserted that nothing less than "a complete breakdown in the statutory framework" would occur

The technical problems to which Section 381(b)(3) was designed to respond can be seen by considering the illustration set out in H.R. Rep. No. 1337, 83d Cong., 2d Sess. A135 (1954). Therein, X Corporation merges into Y Corporation, with Y being the survivor. It is plainly assumed that both X and Y operated independent businesses in prior years, each reporting its separate income or loss. If Y, the surviving entity, incurs an operating loss in the year following the merger, an unrestricted permission to offset that loss against the prior income of both companies obviously presents the need for a rule of apportionment, a rule which would have to be provided by statute or administrative regulation. Thus, suppose X Corporation had substantial taxable income for the year predating the merger, while Y Corporation sustained losses or broke even in the same period. Provisions for the unrestricted carryback of post-merger losses would require that a basis be established for determining whether the later losses should be carried back to the earlier years of X (with a resulting refund) or to the earlier years of Y (with no tax benefit whatever). The same difficulty would be present if one of the two corporations was subject to the corporate surtax in the earlier year, while the other was exposed to the lower normal tax only.

Serious timing problems also would arise if the post-merger losses of Y, the acquiring entity, could be carried back against the pre-merger income of X, the transferor. Thus, suppose the merger takes place just before the end of a taxable year in which Y has sustained an operating loss. Can the loss for the entire year be carried back to offset X's prior income? If so, the effect would be to permit Y to recoup its losses through a year-end acquisition which might be hastily contrived for

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if it did not. (Resp. Br. at 56, Dockets 4561-63, 4562-63, 4563-63; filed August 22, 1966). "Thus, when a large loss is suffered after the combination, how is that loss to be carried back? Is the loss to be carried back to the several predecessors equally or would it be carried back to the predecessor engaged in the kind of business which generated the loss, or according to the relative values of the business, or according to the respective percentages of income earned by the predecessors in the carryback year, or in some manner?" *Id.* at 54-55. None of these difficulties arise as a result of the Aetna reorganization, and it is noteworthy that no impending "breakdown" in statutory function was mentioned by the defendant or by the District Court in the instant case.

that very purpose. Accordingly, a rule of income-proration would have to be included to prevent abuse. See Tiger, *Subsidiary Mergers and (F) Reorganizations*, 28 N.Y.U. Inst. on Fed. Tax. 231, 264 (1970); and Cohen, *The E and F Reorganizations: Use and Abuse*, 31 N.Y.U. Inst. on Fed. Tax. 333, 337 (1973).

These technical difficulties had been carefully studied and analyzed by tax specialists prior to the enactment of the present Internal Revenue Code and were well known to Congress at the time Section 381(b)(3) was adopted.[1] Essentially, two legislative alternatives were then available. The first alternative was one that permitted a carryback of Y's losses against X's prior income, but then accompanied that permission with a requirement that such post-merger losses be apportioned between the two entities by contribution. The approach – essentially that of the consolidated return regulations – would be to determine what portion of the total post-merger loss was attributable to Y's operating business and what portion to the business acquired from X. The proportion of the total loss attributable to each constituent business would then be carried back against the previous income of the entity which had owned that business, but not against the income of the other entity.

This alternative, however, was regarded as unfeasible. Accounting for constituent businesses was thought to be excessively complex from an administrative standpoint. The maintenance of separate records for businesses whose assets, sales force, etc., might be thoroughly integrated following the acquisition would create unusually difficult compliance problems in many cases. In addition, changes in management, product, or operating methods, which might be undertaken for good business reasons after the merger, would often present near-insuperable problems of tracing and identification. See El-

[1] The American Law Institute, whose model *Federal Income Tax Statute* (February 1954 Draft) served in many areas as a basis for the 1954 Code, had concluded that the allowance of carrybacks in corporate mergers would require apportionment, but that this in turn created practical and procedural difficulties which were insurmountable. American Law Institute, Federal Income Tax Statute, Vol. 2 at 331-32 (February 1954 Draft).

dridge, *Net Operating Loss Carryovers in Corporate Acquisitions*, 1956 Nat. Tax Assoc. 72, for contemporary comments on the question by a member of the Treasury's Tax Analysis Staff. As of 1954 when Section 381(b)(3) was enacted, divisional or product-line accounting was not a generally required procedure (it has since become so in the case of companies subject to SEC disclosure rules), so that the tax law virtually alone would have become responsible for a substantial increase in the accounting cost of business acquisitions. Faced with these complexities, there can be no doubt — as the Tax Court indicated in *Estate of Stauffer v. Commissioner*, 48 T.C. 277, 302, *rev'd*, 403 F.2d 611 (9th Cir. 1968), *acquiesced in*, 1975 Int. Rev. Bull. No. 52, at 20 — that Congress deliberately rejected the divisional accounting approach when it adopted Section 381(b)(3).[1]

To avoid such problems of tracing and apportionment, Congress chose to permit the post-merger losses of a merged entity to be carried back against the income of the acquiring corporation only, and prohibited the carryback of such losses against the prior income of the transferor. To be sure, this approach once again emphasized the formal question of which *operating* company survived the merger — if Y were merged into X in the illustration above, any post-merger loss could be offset against X's (instead of Y's) pre-merger income. But plainly this element of formalism seemed less important — especially

[1] Ironically, the courts themselves have authorized rules of apportionment under Section 381(b)(3) by extending the F reorganization definition (somewhat unexpectedly, perhaps) to include multi-business consolidations. *Estate of Stauffer v. Commissioner*, 403 F.2d 611 (9th Cir. 1968), *rev'g*, 48 T.C. 277 (1967); *Associated Machine v. Commissioner*, 403 F.2d 622 (9th Cir. 1968); *Movielab, Inc. v. United States*, 494 F.2d 693 (Ct. Cl. 1974); *Performance Systems, Inc. v. United States*, 382 F. Supp. 525 (M.D. Tenn. 1973), *aff'd per curiam*, 501 F.2d 1338 (6th Cir. 1974); *Eastern Color Printing Co.*, 63 T.C. 27 (1974). In Rev. Rul. 69-185, 1969-1 Cum. Bull. 108, the Internal Revenue Service stated that it would not follow the *Stauffer* and *Associated Machine* decisions; under the Service view, Section 381(b)(3) was intended by Congress to distinguish sharply between "amalgamating reorganizations and the reorganization of a single business." 1969-1 Cum. Bull. at 109. In view of continuing adverse decisions, however, the Service has now revoked Rev. Rul. 69-185 and announced its acceptance of the cases just cited. Rev. Rul. 75-561, 1975 Int. Rev. Bull. No. 52, at 20.

in respect to the short-term carryback relief — than the undesirable complexities of constituent or divisional accounting.

That Congress' aim — and indeed its sole aim — in enacting Section 381(b)(3) was to avoid the need for rules of apportionment is borne out by related elements of the Code structure in this area.[1] Thus, neither B, E nor F reorganizations are subject to an equivalent restriction, even though B reorganizations normally (and E reorganizations occasionally) involve a substantial shift in stock ownership.[2] As noted, B and E reorganizations are not among the transactions enumerated in Section 381(a)(2), while F reorganizations are specifically excepted by Section 381(b)(3). To illustrate the effect, an acquisition by Y Corporation, in exchange for its own voting shares, of all the shares of X Corporation in a transaction qualifying as nontaxable under Section 368(a)(1)(B) would allow X (now Y's subsidiary) to carry back any post-acquisition losses against its pre-acquisition income. The same would be true of a recapitalization under Section 368(a)(1)(E), in which, for example, X, partly owned by Y, exchanged its senior securities for minority shares owned by an outside group. It would be true, also, of a change of place of incorporation under Section 368(a)(1)(F), in which X transfers all of its assets to

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1 That Congress was mindful of the problem of divisional accounting in this field is also shown by the fact that Section 381(a) does not apply to corporate separations in which a single company divides itself in two by spinning off one of its operating businesses. If the original company had net operating losses before the separation, some formula for sharing the loss carryover would have to be devised. But since Congress did not wish to confront the complexities of allocation in Section 381, corporate separations are simply excluded from the section entirely. Cohen, Phillips, Surrey, Tarleau, and Warren, *The Internal Revenue Code of 1954: Carry-overs and the Accumulated Earnings Tax*, 10 Tax L. Rev. 277, 279-81 (1955); Note, *Net Operating Loss Carryovers and Corporate Adjustments: Retaining an Advantageous Tax History Under Libson Shops and Section 269, 381, and 382*, 69 Yale L.J. 1201, 1244-45 (1960).

2 Put differently, a mere change in stock ownership, not involving the combination of two previously separate operating businesses, is not an occasion for elimination of loss carrybacks The extensive discussion of shifts in proprietary interest in the District Court's opinion (Memorandum of Decision 30-33 (A137-A140)) goes solely to a judicially imposed requirement for the characterization of a transaction as an F reorganization. It bears no relationship at all to the policy or general application of Section 381(b)(3).

a newly organized shell corporation chartered in a different state.

What unites these three types of reorganization in the present context is, of course, the absence of those very allocation problems which Section 381(b)(3) was designed to avoid. Because B, E and F reorganizations do not typically entail the combination of two previously separate operating businesses in a single surviving entity, the need to cope with two taxpayers having separate tax histories does not arise. To be sure, another element common to these reorganizations in their simplest textbook forms is that the corporate entity normally seeking to use the loss carryback after the reorganization is the same formal entity which had the use of the carryback before the reorganization. A court which fails to consider more complex variants of these types of reorganization — for example, the reverse subsidiary merger transaction treated by the Service as a B reorganization (see *infra* at 32) — and which is unaware of the policy reasons that motivated Congress to enact Section 381(b)(3), might conclude, as the District Court has done, that the inflexible and invariant rule arbitrarily intended by Congress is that loss carrybacks simply attach to corporations considered as formal legal entities — surviving when the entity survives, perishing when it dies, and available only against prior taxable years of that entity. That Congress should have adopted such a mechanical test, so subject to manipulation and abuse, on the one hand, and pointlessly harsh on acquisition techniques involving shell corporations, on the other, is simply not credible.

The exception for F reorganizations in Section 381(b)(3), and the omission of B and E reorganizations, show very clearly that Congress' only concern was to avoid the complexity of allocation, and that it had no intention to bar loss carrybacks in cases where allocation was unneeded, as in this case. The fact that a change in stock ownership may occur in a B or even an E reorganization does not result in application of the restrictions of Section 381(b)(3) — and indeed it should not, since the refund resulting from the carryback is ultimately credited

to the shareholders who bore the loss. Unwilling to provide a statutory basis for allocation, Congress confined the carry-back to the acquiring corporation in those instances in which it expected two (or more) operating corporations to be involved — that is, in A, C and D reorganizations.[1] Where it anticipated that the profits and losses of only one operating corporation would be at issue — in B, E and F reorganizations — it imposed no restriction whatever.

The merger of Old Aetna into New Aetna quite obviously presents none of the technical allocation problems to which the restrictive rules of Section 381(b)(3) are addressed. New Aetna was created solely for the purpose of enabling Aetna Life to acquire the publicly held shares of Old Aetna. The merger did not entail a combination of separate operating businesses or, indeed, any alteration in the existing status of the casualty company other than a substitution of one formal entity for another. More particularly, the need for allocating or tracing income and loss to an identifiable set of operating assets — a complexity which Section 381(b)(3) is designed to avoid — did not and could not arise for the evident reason that New Aetna owned no assets (other than, for a transitory period and solely to effect the stock for stock exchange, the stock of its parent) and had no prior tax history of its own.

A literal and mechanical application of Section 381(b)(3) in the instant case leads to a pointless abbreviation of the 9-year averaging period which Congress made generally available to

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[1] In addition to subparagraph (3) of Section 381(b), Congress adopted "operating rules" in subparagraphs (1) and (2) which plainly presuppose an amalgamation of two (or more) operating companies with prior histories as taxpayers. Thus, Section 381(b)(1) and (2) require that the taxable year of the transferor corporation close at the date of the transfer. The object was to avoid jumbling the taxable years of two companies which use different fiscal periods — one a calendar year, for example, the other a fiscal year — and likewise to avoid combining the operations of two merged companies during the portions of their taxable years preceding the merger where both happened to use the same taxable year. These points were evidently urged by the government itself in *Associated Machine v. Commissioner*, 403 F.2d 622 (9th Cir. 1968), *rev'g*, 48 T.C. 318 (1967), *acquiesced in*, 1975 Int. Rev. Bull. No. 52, at 20, and *Estate of Stauffer v. Commissioner*, 403 F.2d 611 (9th Cir. 1968), *rev'g*, 48 T.C. 277 (1967), *acquiesced in*, 1975 Int. Rev. Bull. No. 52, at 20. See Pugh, *The F Reorganization: Reveille for a Sleeping Giant?*, 24 Tax L. Rev. 437, 462-64 (1969).

business taxpayers. Referring to the Supreme Court's decision in *New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (1934), the District Court asserted (Memorandum of Decision 17 (A124)) that the aim of Congress was to prevent a corporate taxpayer from "assigning" its carrybacks to "some other company." But of course one cannot "assign" a carryback in any event. Loss carrybacks derive from the post-merger activity of the acquiring company – the question of "assignability" does not arise at all.

The real issue, we submit, is whether Congress intended, as the District Court supposed, to reestablish the criterion of "separate entity" previously associated with the *New Colonial Ice* decision. This criterion was based on the theory that corporate tax attributes stick to a formal corporate entity no matter what happens to the underlying business which generated them. In general, Congress condemned that standard as uncertain, contradictory and artificial. S. Rep. No. 1622, 83d Cong., 2d Sess. 52 (1954). No intention to revive it in the area of loss carrybacks is disclosed in the legislative background of Section 381 and none should be interpolated. To be sure, Congress required that carrybacks be *restricted* to the acquiring corporation, in tax-free asset acquisitions, where their allowance to the transferor as well would necessitate complex rules of inter-company apportionment. But it is inconceivable that Congress intended to *eliminate* carrybacks when apportionment was unnecessary. The stress on "entity," as Judge Magruder observed in *F. C. Donovan, Inc. v. United States*, 261 F.2d 470, 471 (1st Cir. 1958), is a "dry, technical argument" and one which ought not to be determinative where, as here, the wholly unintended consequence is to abort the averaging relief that is provided for in Section 172.

It is of course possible, as the District Court has done, to apply Section 381(b)(3) in a mechanical fashion. But this approach – especially where the complex reorganization provisions of the Internal Revenue Code are concerned – has long been disapproved both by this Court and by the Supreme

Court of the United States. Indeed, the best-known decisions in the field — e.g., *Gregory v. Helvering*, 293 U.S. 465 (1935); *Bazley v. Commissioner*, 331 U.S. 737 (1947) — are those which support the concept that tax statutes should, when possible, be construed in accordance with their purpose. Giving that purpose the recognition it deserves, this Court can and should reverse the District Court on the ground that Section 381(b)(3) has no application to single-company reorganizations even if, as the District Court held, the particular transaction meets the technical conditions of Section 368(a)(1)(C) exclusively. Although the latter holding was itself in error, it ought not, even if correct, be determinative. In adopting Section 381(b)(3), Congress undoubtedly assumed, as explained herein, that the transactions enumerated in Section 381(a) involved at least two entities each of which had had a separate prior history as a taxpayer. As indicated above, the exception and omission of B, E and F reorganizations from the scope of Section 381(b)(3) amply demonstrates this understanding.

An appropriate, sensible and consistent result can be reached in this and all cases by holding, in effect, that Section 381(b)(3) is inapplicable where inter-company apportionment problems are entirely absent. The Court can and should reverse the decision below on the ground that the acquiring "corporation" referred to in Section 381(b)(3) means an entity with at least one prior period of status as a taxpayer or with operating assets of its own. Even more simply, this Court can reverse the District Court's decision on the ground that Section 381(b)(3) has no restrictive effect on the availability of loss carrybacks in single-company reorganizations.

III

IN THE ALTERNATIVE, THE REORGANIZATION OF OLD AETNA AND NEW AETNA SHOULD BE VIEWED AS RESULTING IN AN OVERLAPPING APPLICATION OF SECTION 368(a)(1)(B) AND SECTION 368(a)(1)(C). GIVEN THE LIMITED PURPOSE OF SECTION 381(b)(3), THE RESTRICTION ON CARRYBACKS SHOULD BE IMPOSED ONLY IF THE TRANSACTION IS FOUND TO BE A C REORGANIZATION EXCLUSIVELY, BUT NOT WHEN, AS HERE, IT ALSO QUALIFIES AS A B REORGANIZATION.

The plaintiff has argued that Section 381(b)(3) should not apply to any reorganization, however characterized, when the acquiring corporation is a shell corporation with no prior history as a taxable entity. Therefore, the restrictions of Section 381(b)(3) are inapplicable in this case. In the alternative, the reorganization under consideration qualified as one within Section 368(a)(1)(B), permitting the carryback of subsequent net operating losses incurred to prior taxable periods.

The District Court (Memorandum of Decision 15 (A122)) concedes that if the reorganization of the plaintiff comes within the terms of Section 368(a)(1)(B), the restrictive rules of Section 381(b)(3) do not apply and its net operating loss carrybacks must be allowed. B reorganizations are omitted from the transactions enumerated in Section 381(a) and hence are unaffected by the "operating rules" of Section 381(b) because in a stock-for-stock exchange the acquired corporation is unchanged and no need arises to provide for the transfer of its tax attributes to the acquiring corporation. To illustrate, if Y Corporation acquires all of the stock of X Corporation solely in exchange for a portion of its own voting shares, X becomes a wholly owned subsidiary of Y. Since X and Y continue as separate operating companies, each is free to carry back its postacquisition net operating losses to its own preacquisition taxable years as provided in Section 172. This is true, of course, even if

the acquisition involved 100% of the shares of X Corporation and the former stockholders of X now hold Y shares only. Treas. Reg. §§ 1.381(a)-1(b)(3)(i) and 1.381(c)(1)-1(b) (1960).

The District Court was seriously in error when it determined that the present transaction was one described exclusively by Section 368(a)(1)(C). Properly considered, the merger of New Aetna and Old Aetna qualifies as a B reorganization — that is, as an acquisition by Aetna Life, solely in exchange for its voting stock of the shares of Old Aetna owned by the public stockholders. Conceding that the transaction entailed a transfer of assets within the meaning of Section 368(a)(1)(C), the consequence is merely to create an *overlap* between the B and C reorganization definitions or the C reorganization was simply an integral step in effecting the B reorganization. Under this view, in effect, the reorganization would technically have met the requirements of both subsections. Instances of overlap are common in the tax reorganization field, see B. Bittker and J. Eustice, *Federal Income Taxation of Corporations and Shareholders* at 14-8 (3d ed. 1971), and as shown below, the Internal Revenue Service itself has found a close connection between the B and C reorganization definitions where a single operating corporation is involved.

If the B and C reorganization definitions are found to overlap in the present case, the consequence is that Section 381(b)(3) does not apply and the net operating loss carryback in this case should be allowed. Problems of overlap are generally resolved by reference to the aim and purpose of the provision whose application is at stake. In the present context, involving a single operating corporate enterprise, the policy of Section 172, even as limited by Section 381(b)(3), strongly suggests that any overlap between the B and C reorganization definitions be resolved in favor of allowing the taxpayer's loss carrybacks. Relief from the burden of alternating profit and loss years through averaging is a goal of the Code. The limitation imposed by Section 381(b)(3) — designed solely to avoid the practical problems of divisional accounting — is correspond-

ingly narrow. A corporate reorganization which qualifies under Section 368(a)(1)(B), and which involves a single continuing corporate enterprise, should not be brought within that limitation even if it also technically meets the conditions of Section 368(a)(1)(C). Faced with a similar interpretive issue, the courts have held uniformly that Section 381(b)(3) has no application to F reorganizations even though the same transaction qualifies as an A or a C reorganization or as a liquidation under Section 332. *Movielab, Inc. v. United States*, 494 F.2d 693 (Ct. Cl. 1974); *Performance Systems, Inc. v. United States*, 382 F. Supp. 525 (M.D. Tenn. 1973), *aff'd per curiam*, 501 F.2d 1338 (6th Cir. 1974); *Home Construction Corp. of America v. United States*, 439 F.2d 1165 (5th Cir. 1971); *Associated Machine v. Commissioner*, 403 F.2d 622 (9th Cir. 1968).[1]

The District Court recognized and accepted "that a transaction may be described by two (or more) overlapping subsections of Section 368(a)(1)" (Memorandum of Decision 14, n. 16 (A121)), but held that the present context was not one in which such an overlap should be acknowledged. In so holding, however, the Court refused to apply the reasoning of *Casco Products Corp.*, 49 T.C. 32 (1967), *appeal dismissed* (2nd Cir. 1968), a decision bearing directly on the issue raised here; and it misread the plaintiff's argument regarding the qualification of the reorganization under Section 368(a)(1)(B). In addition, the District Court was plainly moved by what it erroneously assumed to be an inconsistency between the ruling issued by the Internal Revenue Service in 1964 and the present claim for net operating loss carrybacks. These errors, or misperceptions, are considered in order in the discussion that follows.

A. Status of the Reorganization under Section 368(a)(1)(B)

The term "reorganization" is defined by Section 368(a)(1)(B)

[1] These decisions were *acquiesced in* by the Internal Revenue Service in Rev. Rul. 75-561, 1975 Int. Rev. Bull. No. 52, at 20.

to include *either* (1) the acquisition by one corporation, solely in exchange for its voting stock, of stock in another corporation sufficient to constitute control, or (2) the acquisition by one corporation, solely in exchange for stock of its *parent* corporation, of a controlling stock interest in another corporation. Under (1), the acquired concern becomes a first-level subsidiary of the acquiring company. Under (2), since the acquiring company is itself a first-level subsidiary, the acquired concern obviously becomes a second-level subsidiary of the parent corporation whose shares are issued in the exchange.

The District Court apparently thought (Memorandum of Decision 16 (A123)) that the plaintiff sought to qualify under the second wing of the B reorganization definition — that is, as an acquisition *by* a subsidiary of the stock of the acquired concern. In fact, no such contention is made. The present case involves the acquisition of a first-level subsidiary only. The plaintiff contends, quite simply, that the reorganization amounted to an acquisition by Aetna Life, solely in exchange for a portion of its voting stock, of the publicly-owned shares of Aetna Casualty. Technically, Aetna Life incorporated New Aetna as a wholly owned subsidiary and transferred to it stock of Aetna Life. Old Aetna then merged with New Aetna. As a consequence of this merger the minority shareholders of Old Aetna received stock of Aetna Life in exchange for their shares of Old Aetna. The substance and effect of these steps was merely that Aetna Life acquired, for its own voting stock, the outstanding minority interest in its fire and casualty subsidiary.

The Tax Court's decision in *Casco Products Corp.*, 49 T.C. 32 (1967), *appeal dismissed* (2nd Cir. 1968), takes a sensible and realistic approach to the relationship between shell company mergers and Section 381(b)(3); it should have been followed by the District Court.

In *Casco Products*, Standard Kollsman Industries, Inc., by public tender offer, had acquired 91% of the outstanding shares of Casco Products Corp., a Connecticut corporation. The

remaining shares of Casco were held by dissident stockholders who declined to tender. Solely for the purpose of terminating this minority stock interest, Standard Kollsman formed SKO, Inc., a wholly-owned subsidiary with nominal capitalization and then, pursuant to Connecticut law, caused Casco to be merged into SKO, which promptly changed its name to Casco Products Corp. Under the plan of merger, the minority stockholders of Old Casco were compelled to surrender their shares for cancellation in consideration of a stated cash payment. New Casco continued to carry on the business of Old Casco in the same manner as the latter had done previously.

In the taxable year following the merger, New Casco incurred a substantial operating loss which it sought to carry back against the pre-merger income of Old Casco. The Commissioner disallowed the loss on the ground that the merger of New and Old Casco constituted a "reorganization" – presumably under Section 368(a)(1)(A) or (C) – and that Section 381(b)(3) prohibited the carryback of the acquiring corporation's loss to the income of the transferor.

The Tax Court held that the loss was allowable and that the restrictive rules of Section 381(b)(3) did not apply. The Court found that the substance and the reality of the transaction was a "redemption" of the minority shares rather than a "reorganization." Standard Kollsman's purpose throughout was to obtain sole ownership of the stock of Casco Products Corp., and having acquired as many of those shares as it could by tender offer, it then employed the merger as a device for securing the balance. The object of the merger, as authorized by Connecticut law, was to freeze out the minority shares of Casco Products Corp. New Casco, the "acquiring" company, had no function other than to serve as a vehicle for acquiring the outstanding minority interest.

A "straight" redemption by Old Casco itself, as the Court observed, would have raised no doubt whatever about the allowability of the loss carryback:

> There is no question, and indeed, respondent so concedes, that if Old Casco had redeemed the shares of the minority shareholders and had continued in business the loss carryback would have clearly been available. As we see it, the circumstances herein should not produce a different result. To hold otherwise would be to exalt form over substance and to accord an unjustifiable vitality to the merger format which was admittedly adopted only as a "legal technique."
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> 49 T.C. at 36.

The reasoning of the *Casco Products* decision is directly applicable to the present case. Here, as there, the sole purpose of the merger was to obtain for Aetna Life 100% ownership of its fire and casualty subsidiary's shares. Immediately thereafter, all of the subsidiary's shares were redistributed to the parent company's stockholders (including the former stockholders of the subsidiary). If Old Aetna had redeemed the shares of its minority shareholders directly and continued in business, the net operating loss carryback would clearly have been available. Stipulation of Facts, ¶ 38 (A21). As testified by an officer of Aetna Life, Deposition of Stephen B. Middlebrook 6-7, 12-21, 23-30, 39-45, 50-53, 55-64, 73-75, and 78-80 (A55-A91, A95-A100), Aetna Life's aim was not merely to obtain 80% of Old Aetna for the purpose of meeting the conditions of Section 815(f)(3), a step which could undoubtedly have been accomplished by a simple exchange offer, but also to terminate completely the minority stock interest in Old Aetna, so as to avoid for the future all problems of inter-company dealing and conflict of interest. It is true that Aetna Life did not first and unsuccessfully attempt to acquire the minority shares by direct exchange, as Standard Kollsman did in *Casco Products*. That step, however would reasonably have been expected to have left some minority shares outstanding, owing to the sizeable number of Old Aetna's public stockholders, Stipulation of Facts, ¶6 (A14-A15), at least some would surely have failed to respond to an exchange offer through unawareness or inertia. Given the goal of complete co-ownership of the shares of Aetna Life and Aetna Casualty, an exchange offer would thus in any event have

had to be followed by a formal merger[1] into a shell subsidiary in order to complete the acquisition of the subsidiary's shares.

Since the minority shares of Casco Products were acquired for cash, the characterization issue of the *Casco Products* case was one of "redemption" or "reorganization." If the merger of Old Casco into New Casco was seen as a transfer of assets, then the transaction was a "reorganization" and the restrictive rules of Section 381(b)(3) *might* attach.[2] If the merger was seen merely as a legal technique for acquiring the minority's shares, then the transaction was a "redemption" and Section 381 (b)(3) would not apply. As stated, the Court reached the latter conclusion and the carryback was allowed.

In the present case, the consideration received by the public stockholders of Old Aetna was voting stock of Aetna Life, rather than cash as in *Casco Products.* Accordingly, the transaction is in all events a tax-free reorganization and the issue is whether it qualifies as a B or a C reorganization, or both. In applying the *Casco Products* decision to that question, if Standard Kollsman had acquired the shares of Old Casco for voting stock instead of cash, the merger would have been a share-for-share exchange which qualifies as a B reorganization. New Casco would have been regarded as a continuation of Old Casco, the merger would have been viewed as a "legal technique" for effecting an exchange of the parent's shares for the outstanding stock of the subsidiary, and the limitation on loss carrybacks imposed by Section 381(b)(3) would have been inapplicable. As applied to the present case, where stock was the sole medium of exchange, the reasoning of *Casco Products* leads directly to the conclusion that the merger of Old and New Aetna qualifies as a B reorganization.

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1 Here, as in *Casco Products*, both the old and the new subsidiary were Connecticut corporations. The merger of Old Aetna and New Aetna took place under the same authorizing provisions of the Connecticut Statutes (Conn. General Statutes Sections 33-364 to 33-369) as in the *Casco Products* case.

2 The Court reserved the question of whether carrybacks would have been allowable even if there had been a "reorganization." 49 T.C. at 37.

In distinguishing and rejecting the *Casco Products* decision, the District Court appears to have thought that its application here must lead to a finding that no reorganization occurred, which to the Court seemed inconsistent with the taxpayer's successful effort to obtain a ruling from the Internal Revenue Service that the present transaction was a tax-free reorganization qualifying for the relief provided by Congress in Section 815(f). However, the *Casco Products* decision, if applicable here, leads *not* to a conclusion that there was no reorganization, but to the conclusion that the transaction was a valid reorganization under Section 368(a)(1)(B).

The very good sense of the *Casco Products* decision deserves note, especially in view of the District Court's assumption that the decision involved a questionable disregard of the plaintiff's own choice of "form." The Tax Court did not find that the merger between Old and New Casco should be treated as having no legal effect for tax purposes merely because some other procedure might have been chosen instead. The Court did find that the aim of the merger device was to acquire ownership of the subsidiary's minority shares, and then to continue the old operating business as a wholly owned subsidiary. The elimination of carrybacks under those circumstances could have been justified only on the narrowest reading of the statute, and only if the form and the substance of the transaction were treated as perfect strangers. It is true, as the Supreme Court has said, that the courts will not recast transactions in order that taxpayers may escape the tax consequences of their own arrangements. *Commissioner v. National Alfalfa Dehydrating*, 417 U.S. 134, 148-9 (1974). But that is not what the Tax Court did in *Casco Products* and it is not what the plaintiff seeks here. The issue before this Court, as in the *Casco Products* case, is to determine simply what the transaction *was* and what the consequences of it should be.

The District Court observed correctly, Memorandum of Decision 15, n. 17 (A122), that the effect of the merger between Old Aetna and New Aetna was to enable Aetna Life to

freeze out the minority shareholders of Old Aetna. Far from disqualifying the transaction under Section 368(a)(1)(B), this observation simply confirms that the merger served as a "legal technique" for acquiring the publicly owned shares of Old Aetna solely for voting shares of Aetna Life, rather than solely as a means of acquiring "assets" within the contemplation of Section 368(a)(1)(C). Although exchanges under Section 368(a)(1)(B) may frequently be voluntary from the standpoint of the individual stockholders of the acquired company, "voluntariness" is by no means a requirement of that provision. Indeed, the Internal Revenue Service has ruled that a so-called reverse merger – where a shell corporation owning shares of its parent, is merged into an operating subsidiary – may qualify as a B reorganization even though the merger is accomplished by majority vote and the stockholders of the subsidiary are limited to appraisal rights. Rev. Rul 67-448, 1967-2 Cum. Bull. 144.

The Internal Revenue Service itself has indicated that the B and C reorganization definitions are virtually coextensive in circumstances comparable to those in this case.

In Rev. Rul. 57-278, 1957-1 Cum. Bull. 124, a parent corporation owning 72% of the stock of a subsidiary corporation desired to eliminate a widely held 28% minority interest and to obtain sole ownership of the subsidiary's stock. To achieve this end, the parent formed a new shell subsidiary to which a block of the parent's stock was transferred. The new shell subsidiary then acquired the assets of the old subsidiary in exchange for the parent's stock. Following that acquisition, the old subsidiary distributed an appropriate proportion of the parent's stock to the minority stockholders in exchange for their 28% interest and dissolved. As a result, the parent corporation achieved sole ownership of its operating subsidiary, while the former minority stockholders of the old subsidiary became stockholders of the parent.

The Service had ruled under the 1939 Code that the merger of a less-than 80% owned subsidiary *directly* into its parent was

a taxable liquidation rather than a reorganization.[1] Accordingly, the issue in Rev. Rul. 57-278 was whether the Service would take the same position under the 1954 Code where the partly owned subsidiary was merged into a shell company and continued its existence as a separate corporation. The Service held that despite the indirect ownership by the parent of 72% of the subsidiary's assets, the transaction would be regarded as a tax-free C reorganization and not a liquidation under Section 331. The Service reasoned, in effect, that since what was done here could now be accomplished under the 1954 Code through a "creeping" B reorganization, no justification existed for denying its qualifications under Section 368(a)(1)(C):

> It will be noted that in the instant case the same result would have been achieved if the parent corporation had acquired all of the stock of corporation *M* [the old subsidiary] solely for its own voting stock in a 'B' reorganization (meaning reorganizations under section 368(a)(1)(B) of the 1954 Code) and then caused corporation *M* to be reincorporated in another state. Under the 1954 Code, a 'B' reorganization may occur even though the acquiring corporation already owns a large block of stock of the other corporation. It, therefore, seems that the new form of 'C' reorganization acquisition is tax free in a case in which a 'B' reorganization acquisition, in a slightly different form, but having almost the same ultimate effect, would be tax free under the statute.
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> 1957-1 Cum. Bull. at 125.

Of significance to the present case, in Rev. Rul. 57-278 the Service held the transaction to be a C reorganization by direct analogy to the requirements of a B reorganization. If the parent's indirect ownership of the old subsidiary's assets had been disqualifying under Section 368(a)(1)(C) by reason of the Service's earlier ruling, the transaction apparently would have been held to be a tax-free B reorganization followed by a reincorporation of the old subsidiary. It seems evident that the Service viewed the B and C reorganization definitions as hav-

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[1] Rev. Rul. 54-396, 1954-2 Cum. Bull. 147; and see, *Bausch & Lomb Optical Company v. Commissioner*, 267 F.2d 75 (2nd Cir. 1959), *cert. denied*, 361 U.S. 835 (1959).

ing a near-equivalent application in circumstances that cannot be distinguished from those at issue here.

Very much the same viewpoint is revealed by the Service's general position regarding triangular mergers. In Rev. Rul. 67-448, 1967-2 Cum. Bull. 144, P Corporation desired to acquire all the outstanding shares of Y Corporation, both entities being publicly held, operating corporations. To avoid the possibility of minority stockholders in Y if less than 100% of Y's stockholders should agree to the exchange, P formed S, a wholly-owned shell corporation, transferred to S an appropriate number of P's voting shares, and then merged S into Y. Some 5% of the Y stockholders dissented from the merger and received cash for their shares, but the balance of Y's stockholders accepted P stock in exchange for their Y stock and Y thus became a wholly-owned operating subsidiary of P. The Service held that the transaction qualified as a reorganization under Section 368(a)(1)(B)[1]. In explaining its conclusion that the transaction between P and Y qualified as a B reorganization despite the intervention of S, the Service observed:

> It is evident that the shortest route to the end result described above would have been achieved by a transfer of P voting stock directly to the shareholders of Y in exchange for their stock. This result is not negated because the transaction was cast in the form of a series of interrelated steps. The transitory existence of the new subsidiary, S, will be disregarded. The effect of all the steps taken in the series is that Y became a wholly owned subsidiary of P and P transferred solely its voting stock to the former shareholders of Y.
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> 1967-2 Cum. Bull. at 145.

Consistent with its stress on surviving entity, the Service has ruled that a forward merger — where, in effect, Y merges into S and S is the survivor — will be treated as a C reorganization, even though the end result from the standpoint of all the parties in interest is exactly the same as that reached in reverse mergers. Rev. Rul. 67-274, 1967-2 Cum. Bull. 141.

[1] See also Rev. Rul. 74-564, 1974-2 Cum. Bull. 124, and Rev. Rul. 74-565, 1974-2 Cum. Bull. 125, extending Rev. Rul. 67-448 to even more complex exchanges.

Since the two procedures have the same ultimate effect and differ only slightly in formal terms, the Service could undoubtedly have treated the B and C reorganization definitions as jointly applicable no matter which direction the merger had taken.

As the District Court implied, Memorandum of Decision 17 (A124), differences between the several reorganization definitions in Section 368(a)(1) sometimes make it necessary to stress narrow distinctions between equivalent transactions. However, this means that the courts will not and may not supply formal elements that are lacking in a transaction, or withdraw formal elements that are disqualifying, in an effort to satisfy the requirements of the statute. This does not mean that the reorganization definitions do not overlap and must always be kept separate. Note for example the overlap in application of the reorganization provisions in *Home Construction Corp. of America v. United States*, 439 F.2d 1165 (5th Cir. 1971), *acquiesced in*, 1975 Int. Rev. Bull. No. 52, at 20. In the plaintiff's view, the reorganization was nothing more or less than a pick-up of the minority shares of Aetna Casualty by its parent corporation. As such, the transaction is properly regarded as a B reorganization of Old Aetna. Conceding that the transaction also meets the requirements of Section 368(a)(1)(C) because it involved an acquisition of the assets of Old Aetna by New Aetna as an incident of the stock for stock exchange between Aetna Life and the plaintiff, this Court should recognize the existence of a definitional overlap in the present case, and should hold that the B and C reorganization definitions are, on these facts, jointly applicable.

If the Court does find that the B and C reorganization definitions overlap in the present case, the restrictive rules of Section 381 (b)(3) do not apply because the involved business continues unchanged, and hence, Sections 381(a) and 381(b)(3) are totally inapplicable. The same conclusion follows if the reorganization is viewed as a B reorganization followed by a reincorporation under Section 368(a)(1)(F), be-

cause Section 381(b)(3) is inapplicable to B reorganizations and F reorganizations are specifically excepted therefrom. The possibility that a transaction may also qualify as a C reorganization is not relevant for this purpose. Section 381 was designed to *permit* the carryover of selected tax attributes in transactions where those attributes would otherwise be cut off, that is, in transactions qualifying *exclusively* as tax-free asset acquisitions. When the continuation of tax attributes does not depend upon Section 381, as in the case of B or F reorganizations, neither the authorizing nor the limiting provisions of that section are applicable.[1]

The critical point to observe is that Section 381(b)(3) is aimed solely at avoiding the practical and procedural difficulties of allocating income and loss between two previously separate operating corporate taxpayers. Where the need for allocation is lacking, the subsection would, if applicable, lead to a pointless elimination of net operating loss carrybacks, a consequence at odds with the purpose of Section 172 which should not be sanctioned unless very clearly intended by Congress. If the Aetna reorganization is found to fit within the B and C reorganization definitions alike, the conflict or overlap

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1 Transactions falling outside of Section 381(a) are not intended to be affected by that Section. As stated in H.R. Rep. No. 1337, 83d Cong., 2d Sess. A135 (1954), "No inference is to be drawn from the enactment of this section whether any item or tax attribute may be utilized by a successor or a predecessor corporation under existing law." As the Service itself has recognized, the governing principle in such circumstances is to be found in *Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957), where the Supreme Court held under the 1939 Code that the losses of a constituent business in a statutory merger could be offset against (but only against) the income of the same business. Rev. Rul. 59-395, 1959-2 Cum. Bull. 475. The present case falls precisely within that rule. New Aetna had no business prior to the reorganization, and merely continued without change the business of Old Aetna thereafter. Stipulation of Facts, ¶¶ 22, 26, 38 (A18-A19, A21). Realistically, the Aetna reorganization was a B reorganization, an exchange of voting shares of Aetna Life for the minority shares of Aetna Casualty. It did entail a statutory merger into a successor entity whose function was to assure that the minority interest would be terminated. Assuming that Section 381(b)(3) is not applicable, the result under *Libson Shops* and Rev. Rul. 59-395 is that the plaintiff's net operating losses for 1964 and 1965 are allowable, and indeed are only allowable, against the prior income of the same operating business.

should be resolved in the light of this statutory design.[1] In turn, this means that Section 381(b)((3) should be held inapplicable in the present case and that the plaintiff's net operating loss carrybacks should be allowed.

B. The Prior Ruling under Section 815(f)

The District Court emphasized that the parties, to qualify the ultimate distribution of stock to Aetna Life shareholders under Section 815(f)(3)(B), sought and obtained an Internal Revenue Service ruling that the reorganization constituted a C reorganization, that Aetna Life thereby obtained a tax benefit,[2] and that "[n]ow (after the statute of limitations has long since run for the IRS to challenge the tax treatment accorded Aetna Life) New Aetna seeks to receive additional benefits on an inconsistent theory." Memorandum of Decision 13 (A120). Because of the alleged inconsistency, "not giving effect to the form would risk improper tax treatment in this case." Memorandum of Decision 12 (A119). The District Court perceived the plaintiff as being inconsistent by trying to recharacterize the erstwhile C reorganization as a B reorganization. Memorandum of Decision 12-13, 18-20 (A119-A120, A125-A127).

The alleged inconsistency between the C ruling and the B argument now advanced is clearly misconceived. First, if

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[1] It is notable that in the recently issued Rev. Rul. 75-561, 1975 Int. Rev. Bull. No. 52, at 20, the Internal Revenue Service held that the merger of a wholly-owned subsidiary into its parent, though otherwise generally treated by the Service as a liquidation under Section 332 (Treas. Reg. § 1.332-2(d) (1955), now "constitutes an F reorganization, *for purposes of section 381(b)(3)*." (Emphasis added). The implication is that the overlap between Section 332 and Section 368(a)(1)(F) is governed by the aim of the statutory rule whose application is at issue, which is precisely what the plaintiff seeks.

[2] It should be pointed out that Section 815(f)(3)(B) was not a purely private relief provision, as the District Court appeared to think, but was justified by considerations of general applicability. Indeed, it was an extension on equitable grounds of a benefit that had been enacted for other companies in 1962 (Pub. L. No. 87-858, 76 Stat. 1134; *See* S. Rep. No. 1428, 88th Cong., 2d Sess. 10-11 (1964)), and whose aim was to facilitate the removal of the securities of an operating subsidiary from the status of investment assets under the Life Insurance Company Income Tax Act of 1959. *See generally* Clark, *The Federal Income Taxation of Financial Intermediaries*, 84 Yale L. J. 1603, 1637-57 (1975).

Aetna Life had sought and obtained a ruling that the merger was a B reorganization, it would nevertheless have obtained the same relief from the life insurance company income tax provided by Section 815(f)(3)(B). By its own terms Section 815(f)(3)(B) would have applied whether the merger constituted an A, a B, or a C reorganization. Secondly, as the argument above demonstrates, it would have been entirely proper for Aetna Life to seek and for the IRS to grant a ruling request that the merger be considered a B reorganization within clause (i) of Section 815(f)(3)(B). New Aetna, as the formal equivalent of Old Aetna, would be the "controlled corporation" therein referred to. Thirdly, the fact that the ruling request in fact specifically asked for a C characterization was simply a function of the Service's then preferred description of forward subsidiary mergers, a description which has since been explicitly covered by Section 368(a)(2)(D). Fourthly, and perhaps most importantly, the fact that the formal aspects of the merger and subsequent distribution appear to fit more obviously and "naturally" under clause (ii) rather than clause (i) of Section 815(f)(3)(B) is not rationally relevant to the carryback issue involved in this case. Clause (i), covering B acquisitions of shares of controlled fire and casualty companies, and clause (ii), covering indirect acquisitions using the technique of an A or C reorganization, were both included in order to cover the full variety of formal techniques for achieving the desired spin-off of controlled fire and casualty subsidiaries. The two clauses read together imply that Congress felt the choice among the A, B or C techniques to be irrelevant for purposes of the remedial aim of Section 815(f)(3)(B). Given this inclusive intent, the provision cannot be read as purporting to list mutually exclusive categories of reorganizations.

More generally, Section 815(f)(3)(B) is simply not a definitional provision. Clauses (i) and (ii) of that Section do not purport to state what *is* a tax-free reorganization, and they certainly do not foreclose a finding under Section 368(a) that a given transaction meets the definitional requirements of more

than one subparagraph of Section 368(a)(1). The conditions for qualification for relief from the life insurance company income tax under Section 815(f)(3)(B) simply have no logical connection with the issue of characterization raised in this appeal.

CONCLUSION

In order to eliminate the publicly held 38.39% minority interest in its fire and casualty subsidiary, Aetna Life organized a wholly owned shell corporation which merged with the fire and casualty company, following which Aetna Life owned 100% of the fire and casualty company and the former minority shareholders owned stock of Aetna Life. While the Internal Revenue Service ruled that this transaction qualified as a C reorganization, the transaction technically and substantively qualified as a B reorganization as well — an acquisition by Aetna Life, solely in exchange for its voting stock, of the publicly owned shares of the fire and casualty company. As the Tax Court observed in the *Casco Products* case:

> There is no question, and indeed, respondent so concedes, that if Old Casco [Old Aetna] had redeemed the shares of the minority shareholders and had continued in business the loss carryback would have clearly been available. As we see it, the circumstances herein should not produce a different result. To hold otherwise would be to exalt form over substance and to accord an unjustifiable vitality to the merger format which was admittedly adopted only as a "legal technique."
> 49 T.C. at 36.

Since the reorganization in this case meets the technical and substantive requirements of a B reorganization, the restrictions on carrybacks in Section 381(b)(3) do and should not apply. Furthermore, since the legislative purpose of Section 381(b)(3) was simply to avoid the practical and technical difficulties of divisional accounting, difficulties which arise only when two operating companies are combined and which are therefore not present in this case, the carryback of net

operating losses incurred by the plaintiff subsequent to the reorganization to periods prior thereto should not be barred.

The plaintiff requests that the judgment of the District Court entering Summary Judgment in favor of the defendant be reversed and remanded with directions to enter Summary Judgment in favor of the plaintiff. The plaintiff would be entitled to judgment in the amount of $4,467,630.59, representing $4,071,655.21 in Federal income tax and $395,975.38 of deficiency interest, plus interest thereon as provided by law.

Respectfully submitted,

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ADDENDUM

RELEVANT STATUTES
INTERNAL REVENUE CODE OF 1954 (26 U.S.C.):

SECTION 172. NET OPERATING LOSS DEDUCTION.

(a) Deduction Allowed. — There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

(b) Net Operating Loss Carrybacks and Carryovers. —

(1) Years to which loss may be carried. —

(A)(i) Except as provided in clause (ii) and in subparagraphs (D), (E), (F), and (G), a net operating loss for any taxable year ending after December 31, 1957, shall be a net operating loss carryback to each of the 3 taxable years preceding the taxable year of such loss.

* * * *

(B) Except as provided in subparagraphs (C), (D), and (E), a net operating loss for any taxable year ending after December 31, 1955, shall be a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss.

* * * *

SECTION 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) Reorganization. —

(1) In general. — For purposes of parts I and II and this part, the term "reorganization" means —

(A) a statutory merger or consolidation;

(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring

corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition);

(C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded;

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

(E) a recapitalization; or

(F) a mere change in identity, form, or place of organization, however effected.

° ° ° °

SECTION 381. CARRYOVERS IN CERTAIN CORPORATE ACQUISITIONS.

(a) GENERAL RULE. – In the case of the acquisition of assets of a corporation by another corporation –

(1) in a distribution to such other corporation to which section 332 (relating to liquidations of subsidiaries) applies, except in a case in which the basis of the assets distributed is determined under section 334(b)(2); or

(2) in a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D) (but only if the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met), or (F) of section 368(a)(1),

the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described in subsection (c) of the distributor or transferor corporation, subject to the conditions and limitations specified in subsections (b) and (c).

(b) OPERATING RULES. – Except in the case of an acquisition in connection with a reorganization described in subparagraph (F) of section 368(a)(1) –

° ° ° °

(3) The corporation acquiring property in a distribution or transfer described in subsection (a) shall not be entitled to carry back a net operating loss or a net capital loss for a taxable year ending after the date of distribution or transfer to a taxable year of the distributor or transferor corporation.

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SECTION 815. DISTRIBUTIONS TO SHAREHOLDERS.

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(f) DISTRIBUTION DEFINED. – For purposes of this section, the term "distribution" includes any distribution in redemption of stock or in partial or complete liquidation of the corporation, but does not include –

° ° ° °

(3) any distribution after December 31, 1963, of the stock of a controlled corporation to which section 355 applies, if such controlled corporation is an insurance company subject to the tax imposed by section 831 and if –

(A) control was acquired prior to January 1, 1958, or

(B) control has been acquired after December 31, 1957 –

(i) in a transaction qualifying as a reorganization under section 368(a)(1)(B), if the distributing corporation has at all times since December 31, 1957, owned stock representing not less than 50 percent of the total combined voting power of all classes of stock entitled to vote, and not less than 50 percent of the value of all classes of stock, of the controlled corporation, or

(ii) solely in exchange for stock of the distributing corporation which stock is immediately exchanged by the controlled corporation in a transaction qualifying as a reorganization under section 368(a)(1)(A) or (C), if the controlled corporation has at all times since its organization been wholly owned by the distributing corporation and the distributing corporation has at all times since December 31, 1957, owned stock representing not less than 50 percent of the total combined voting power of all classes of stock entitled to vote, and not less than 50 percent of the value of all classes of stock, of the corporation the assets of which have been transferred to the controlled corporation in the section 368(a)(1)(A) or (C) reorganization;

* * * *

Paragraphs (3), (4), and (5) shall not apply to that portion of the distribution of stock of the controlled corporation equal to the increase in the aggregate adjusted basis of such stock after December 31, 1957, except to the extent such increase results from an acquisition of stock in the controlled corporation in a transaction described in paragraph (3)(B). If any part of the increase in the aggregate adjusted basis of stock of the controlled corporation after December 31, 1957, results from the transfer (other than as part of a transaction described in paragraph (3)(B)) by the distributing corporation to the controlled corporation of property which has a fair market value in excess of its adjusted basis at the time of

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the transfer, paragraphs (3), (4), and (5) also shall not apply to that portion of the distribution equal to such excess.

* * * *

SECTION 832. INSURANCE COMPANY TAXABLE INCOME.

* * * *

(c) DEDUCTIONS ALLOWED. — In computing the taxable income of an insurance company subject to the tax imposed by section 831, there shall be allowed as deductions:

* * * *

(10) deductions (other than those specified in this subsection) as provided in part VI of subchapter B (sec. 161 and following, relating to itemized deductions for individuals and corporations) and in part I of subchapter D (sec. 401 and following, relating to pension, profit-sharing, stock bonus plans, etc.);

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